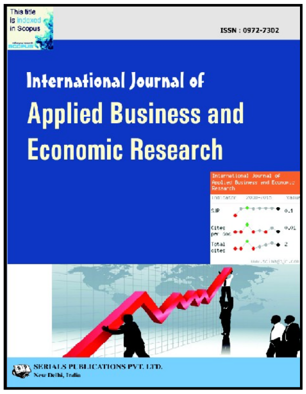

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The Next Financial Crisis: 'Made in China'

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Abstract: Many of the developing nations could not insulate themselves from the detrimental impact of the Debt Crisis of Europe and the Credit Crisis of the US. The People's Republic of China has been flaunting a growth rate many nations would envy. Its increasing incomes of the middle class, ever rising stock market valuations and a current account surplus all have only made China to be seen through the spectacles of optimism. Post the 2008 Crisis, at the helm of shrinking prospects of overall global trade, China has been aggressively pushing to achieve its growth targets by over borrowing both internally and externally. The proposed paper studies how China has accumulated too much debt in a very short span of time and is now facing a financial crisis like situation. The paper will study the implications of China's accumulation of debt on itself and the causes of such high debt. It explains how the debt bubble so created has now replaced China with the US as a nation with too much debt to its GDP. China has estimated 281% Debt to its GDP with a total of 28.1 Trillion dollars of debt. The paper criticises certain attempts by the government of pressing hard on growth at the expense of devaluation of its own currency to the US Dollar and further studies the deep impact of the crisis that has led to the problem of deflation, falling stock prices, over capacity and some draconian methods by the government that have aggravated the situation. The paper will elucidate the overall outcome and effects Chinese Debt can have on world economy in further days to come. It will focus on further problems that the country can possibly face as it's running out of growth drivers. As China's population ages and world trade keeps shrinking, situations ahead for the country is explained in detail in the presented paper. The paper takes full cognisance of the facts and subsequent macro-economic scenario and thus proposes a financial model that can subdue the full blown crisis. It proposes ways to tackle the problem of deflation in an economy without forcibly applying restraint. The paper proposes to reduce overall national debt and focuses on the principle of organic growth driven by consumption and not artificially spiked investments. The paper focuses on participation for the greater good of the society and overall economic growth.

Keywords: China, Financial Crisis, Debt Bubble, Over Capacity, National Debt, Over Borrowing

BACKDROP OF THE CRISIS

The year 2008 saw the US grappled with the subprime mortgage market crisis that had tremors which were felt across the world. During this phase global GDP actually shrunk and GDP growth rate went negative as seen in Figure 1. Subsequently, it was expected that global demand will be bleak. China, on the other hand had secured a place for itself that many developed nations would envy. It had created capacity for itself to such a level that it was then called as 'exporter to the world'. However, a weak global economy meant even China would suffer due to the 2008 Crisis. China's biggest trade partners US, Japan and South Korea all were grieving in the aftermath of the crisis. When markets abroad were going dry, China knew it had to spike demand from within the country. This was when China adopted the policy to spur growth by easing liquidity in its own market. Chinese banks lent money to businesses, individuals and corporations fair and square. At the time of the 2008 crisis, the country had about 150 percent debt to nominal GDP ratio as seen in Figure 4. However, today it has up surged to about 281 percent (National Debt, 2017). China stands a staggering 28.1 Trillion Dollars of debt (Balding, 2016). This heavy indebtedness is giving rise to a financial Crisis in hind sight.

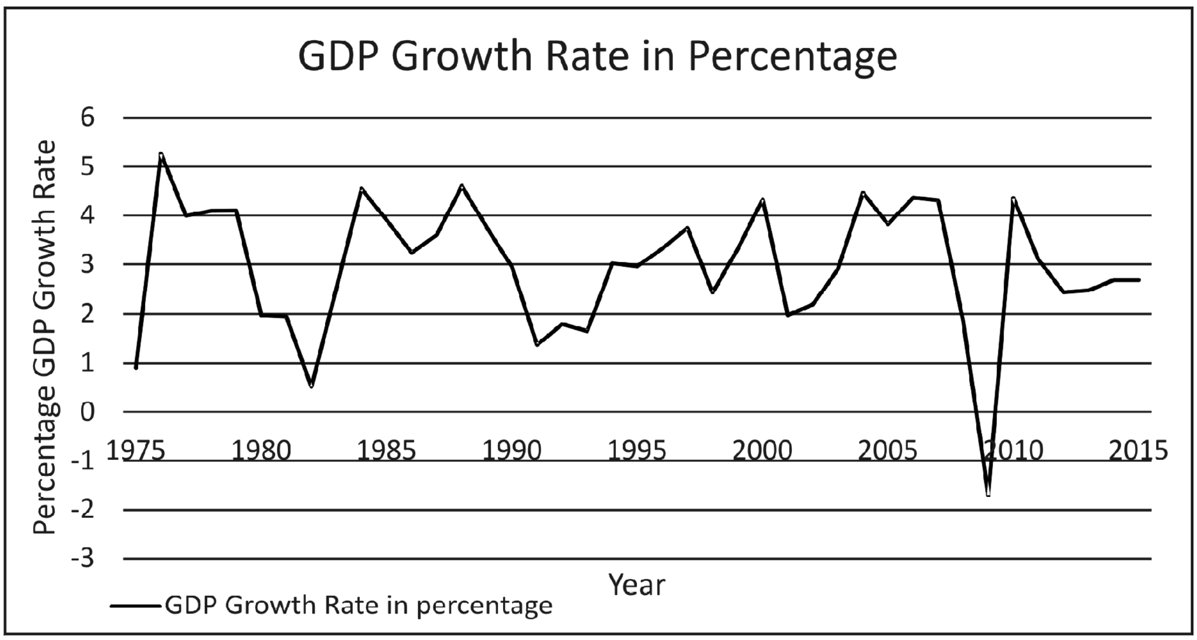

Figure 1: World GDP Growth Rate, 2016. Adapted from

http://data.worldbank.org/ Retrieved from http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2015&locations=CN&start=1961&view=chart. Adapted with permission.

WHY CHINA INFUSED SO MUCH LIQUIDITY IN THE SYSTEM

Post World War 2 the title of being the exporters to the world was governed mainly by Japan and Germany. However, post the war as global demand shrunk and both Germany and Japan were hit by an economic crisis graver than the crisis that hit the US. Fearing a repeat of history in case of China in the aftermath of 2008 Crisis. As China's export figures dwindled as seen in Figure 2, the country very hurriedly took corrective actions and infused liquidity into the system by tweaking its fiscal and monetary policy. The government's vision was to spur demand locally to sustain its very ambitious GDP growth targets. The government thus started spending on infrastructure development and also encouraged banks to lend more so as to boost the economy.

The Chinese government had also gained the trust of the people through impeccable growth rate the economy had witnessed and the rise in middle class incomes. Thus, it was imperative on the regime to sustain the same so as to safeguard its own future for governing such a huge and highly populated country. All these circumstances led to China becoming desperate to maintain such a high level of growth and as means to achieve that growth rate it resorted to infusing humongous amount of liquidity in the system.

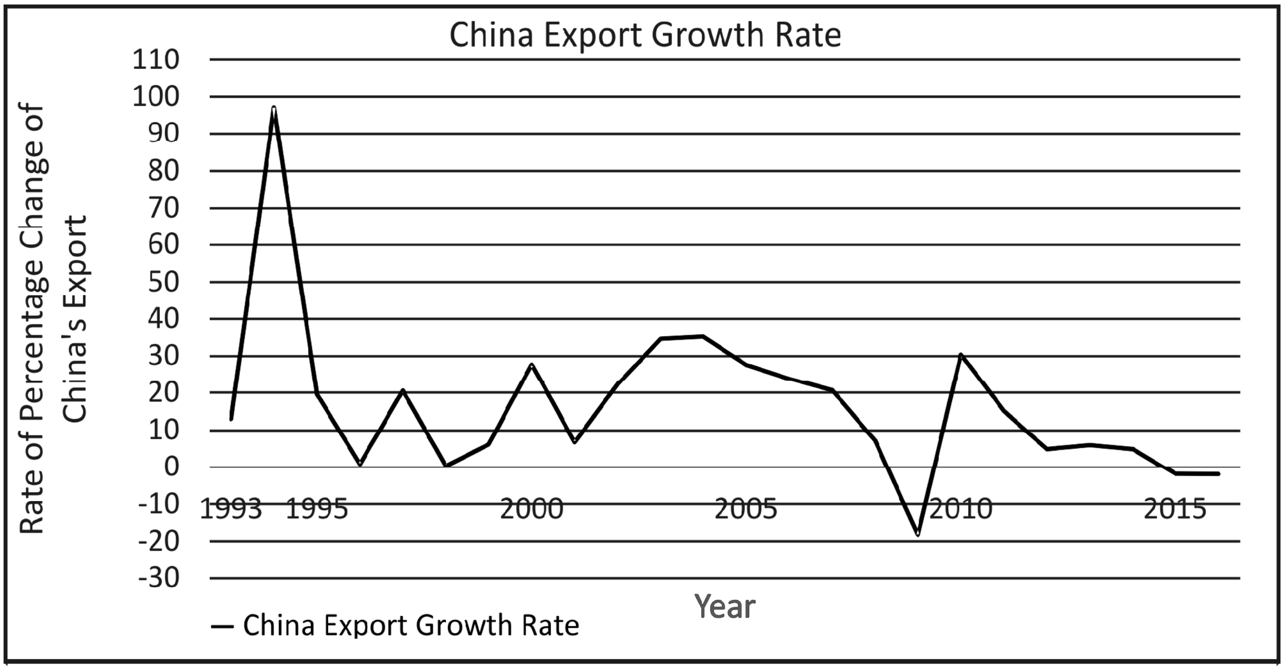

Figure 2: China's Export Growth Rate, 2016. Adapted from CEIC Data, (2017). Retrieved from

https://www.ceicdata.com/en/indicator/china/total-exports-growth . Adapted with permission.

THE APPLE OF DISCORD: RISE IN DEBT

China's debt was increasing ever since it began its journey to become a superpower. However, till 2008 even if China's debt grew at about 14 percent year on year so did China's nominal GDP grow at about 15 percent as seen in Figure 3, thus the mounting debt wasn't an issue of much concern as growing economic activity had the strength to sustain the same. However, today China's GDP growth rate is even more sluggish at about 6.7 percent while the growth in debt stays unchecked.

As China focuses to further grow it must set an achievable target and try to contain the rate of the rise of growth in debt. Adopting draconian methods such as stopping new infusion of debt or infusing too much debt in the economy will prove much more harmful to the economy.

In the advent of slow over all global growth influx of fresh foreign funds is a distant dream. Most, foreign investors turned a blind eye towards investing in emerging markets. (Woods, 2008)

Thus, country must take a balanced approach and try to sustain a reasonable figure for the same.

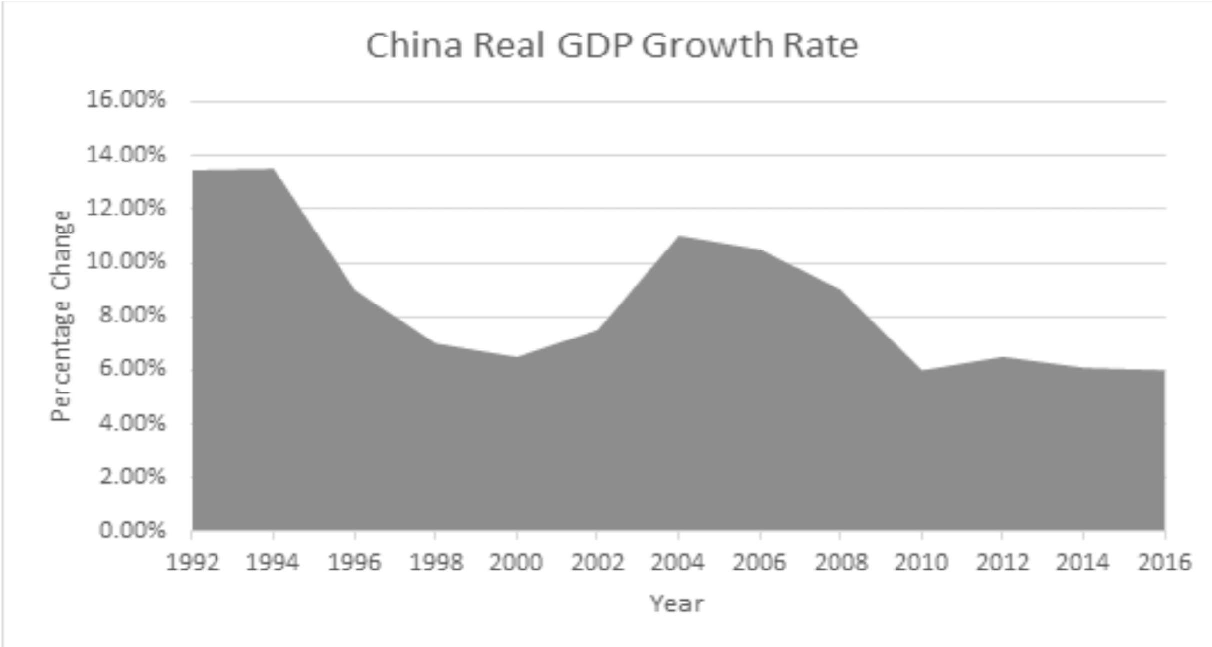

Figure 3: China GDP Growth Rate YOY Adapted from CEIC Data, (2017). Retrieved from *https://www.ceicdata.com/en/indicator/china/real-gdp-growth. Adapted with permission.*

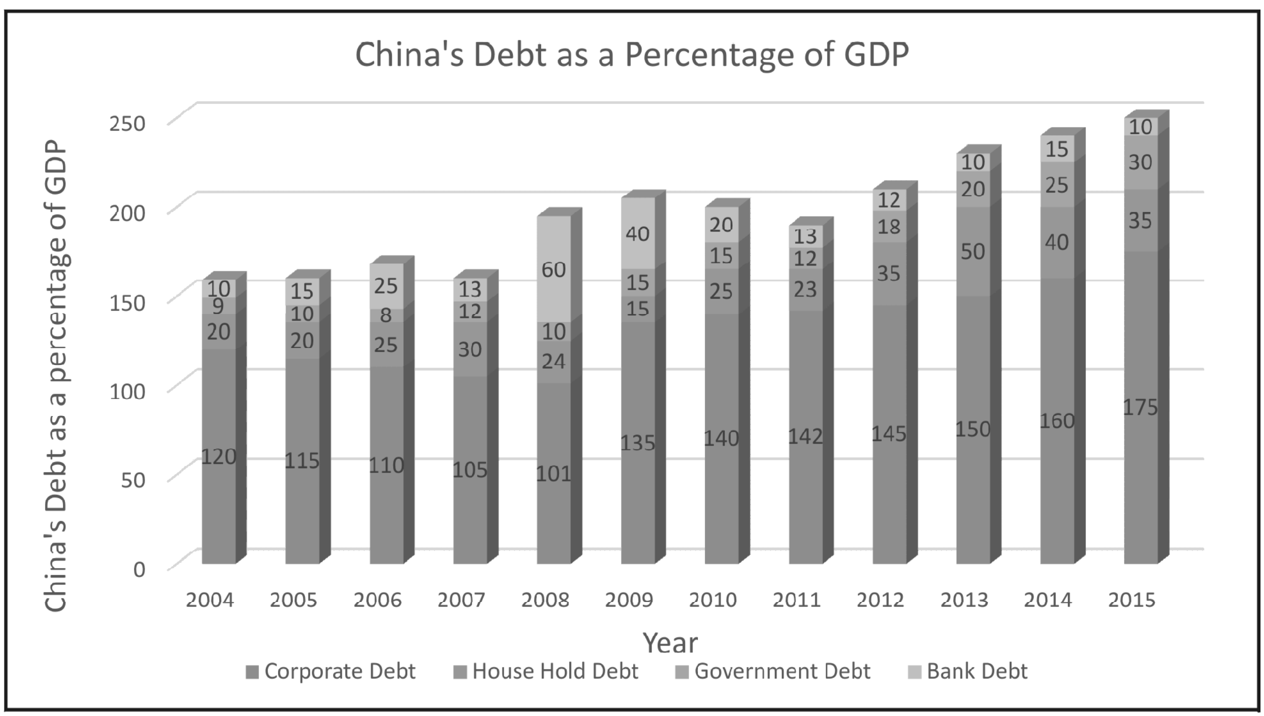

Figure 4: Digging into China's growing mountain of debt. Adapted from Bloomberg. Retrieved from *https://www.bloomberg.com/professional/blog/digging-chinas-growing-mountain-debt/*

BREAKUP OF CHINA'S DEBT

It is known that about 145 % of its debt to nominal GDP is attributed to corporate debt. This translates to about 14.5 Trillion US Dollars of Debt. However, IMF estimates about 15 percent of these loans are bad debts which translates to roughly 2 Trillion US Dollars. (Zhao & Adams 2017).

Much more than household and government loans the cause of concern is actually the corporate loan book, as for some of the companies the money that was lent to were actually zombie companies.

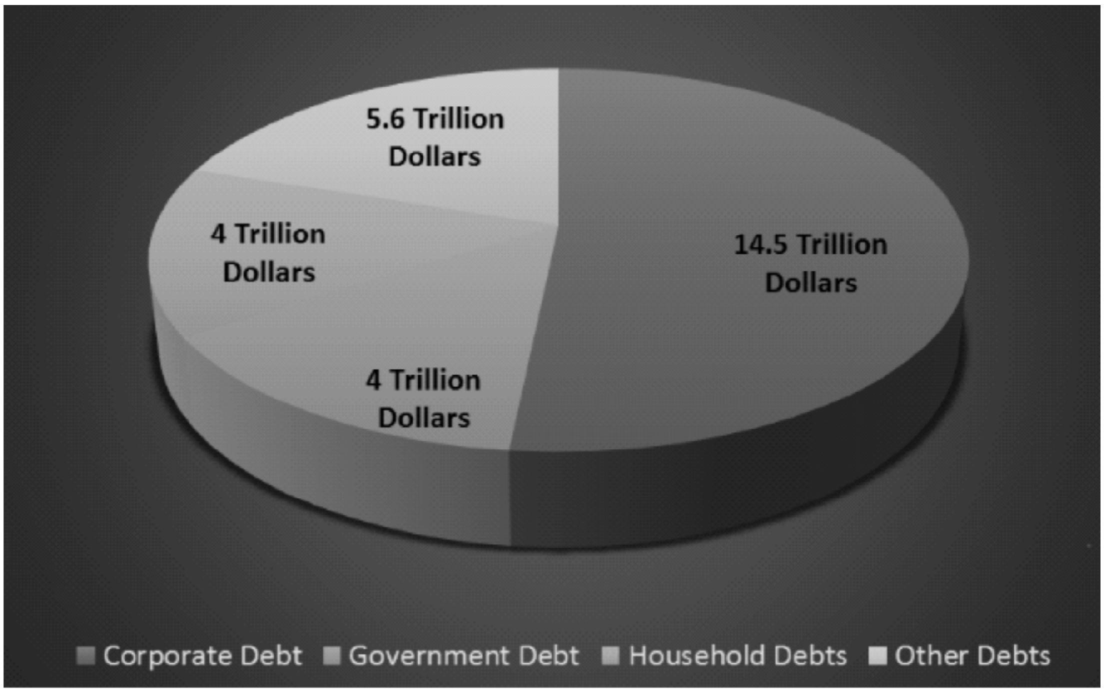

Figure 5: Digging into China's growing mountain of debt. Compiled from Bloomberg. Compiled from

https://www.bloomberg.com/professional/blog/digging-chinas-growing-mountain-debt/

PERIPHERAL EFFECTS OF THE CRISIS

China went on its borrowing spree post 2008 crisis. It pushed prices as low as it could both in the international market as well as in its own domestic market. This led to some of the ruinous economic conditions for the country which is deflation. Prices of commodities kept falling and this worsened the situation. China now possesses over capacity and to make situations graver it also has to face very low demand in its domestic market. (Ding & Sheng, 2016) Low exports hampered China's growth story abroad, while a weak demand within the country made the situation bad to worse for the economy.

CHINA'S CATCH 22 SITUATION

The country is strongly based upon principles of communalism. The economic boost China enjoyed since 2008 made the country's Government gain the trust of the people. However, today as factories have shut down and Industrial Production Index as seen in Figure 6 isn't very impressive any more, the Government is in the midst of a dilemma. Not sacking workers to cut costs would mean not taking corrective actions to

Figure 6: China's Industrial Production Index. Adapted from CEIC Data, (2017). Retrieved from *https://www.ceicdata.com/en/indicator/china/industrial-production-index-growth. Adapted with permission*

repair the economy, while on the other hand sacking workers will go against communalism principles and this can even lead to public unrest. (Andreosso & Gottwald, 2013). As most companies are State Owned Enterprise (SOE), general public will hold the Government machinery responsible for their loss of job and this can even lead to civil disobedience kind of situation. This has put China in a fix. It has to bite the bullet really hard to fix this mess

CHINA'S GHOST CITIES

To incentivise internal trade within the country China decided to boost its real estate market. Chinese real estate developers started building not apartments or houses but entire cities. With most funds coming in from banks due to availability of cheap credit, developers went on building without the urge to sell. Today, there are over dozens of cities in China with abysmally low number of residents. However, most real estate development companies today have a huge firm size and thus the sheer size of the firm can be a saviour for the crisis. (Kiani, 2017)

Many buildings aren't even complete owing to the current economic downturn.

CHASING GROWTH AT THE COST OF CURRENCY DEVALUATION

China a primarily being an export oriented economy tried hard to salvage its export growth. China devalued its currency to the US dollar on two occasions in 2015. (Perumal, 2017) This helped China to be able to keep the price of goods produced in China at a very low rate. But the overall practice created huge panic and uncertainty around the world.

Also China does have substantial external borrowings as part of its total debt. This has made situation even worse as now repayment of debt in a weaker currency is even more difficult.

CHINA'S STOCK MARKET BUBBLE FUELLED BY MARGIN LENDING

From June 2012 China's stock markets rocketed and reached new highs until early February 2016. However after June 2015, stock market engine ran out of growth drivers and this was when Shanghai Stock Market fell by at least 30 percent.

Before the downfall began Chinese Government had encouraged ordinary citizens to venture into stock market trading as retail traders. Chinese state owned media tried to create a wave of optimism which boosted sentiments of general public at large. It also encouraged banks to offer margin loans to encourage people to invest more in equity. All this lead to stock markets soaring high like never before. However, some companies listed on the market were zombie companies which were trading at exorbitant valuations. Genuine companies too faced hardships as they had too much debt on their balance sheet. When such facts came to light, it degraded the situation and eventually the stock market crashed.

However, it was estimated that the current down turn by China's economy will continue to persist not just because of the stock market crash. (Country Reports China, 2015).

As speculative trading was done on margin lending the losses incurred were colossal and this only worsened the situation further.

EFFECT ON EMERGING MARKETS

As Chinese debt crisis is mostly within the country there were very few repercussions on emerging markets (EM) globally in a direct way. However the indirect effect of the crisis is far reaching and heinous. Firstly, as China depreciated its currency to keep its trade afloat and there was huge uncertainty as it affected the US dollar and this eventually had deeper effects overall. China's debt has some exposure in US dollar hence any defaults will create a huge burden on the world economy.

Also, FPI and FII don't treat every emerging nation separately, no matter how promising the nation is, they treat all EMs as a class of assets put together. Thus any bad news in China triggers an EM out flow and overall markets in all EMs eventually have a free fall.

This lead to massive loss on valuation in all EMs.

FINANCIAL MODEL TO TACKLE THE EFFECTS

The Chinese government took a number of corrective steps to contain this crisis. However, the final aim to boost economy again went in vain, as despite these efforts Chinese GDP growth rate shrunk to, a 25 year low of, about 6.7 percent as against 6.9 Percent GDP growth rate last fiscal year. The epicentre of China's problems today is its mounting debt problem. Hence, reducing debt should be China's sole aim at this point of time. The following is the list of activities that China should undertake to contain its crisis.

1. Try to bring down China's Debt to GDP ratio from the current 281 percent to below 200 percent as its initial target.

2. Try to balance rate of growth of Debt with rate of growth Nominal GDP. Set a reasonable target to achieve the same.
3. Accept a low economic growth rate and let economy function indigenously, contingent upon consumption and not on artificially spiked investments.
4. Stop devaluing Yuan further as China's external debt is anyway skyrocketing, a weak currency would mean further aggravated problems for the economy,
5. Take corrective actions on China's Margin Lenders.
6. Have strict governance policy and get rid of zombie companies.
7. Take into account the deflation problem and lower interest rate to a near zero or even negative.

CONCLUSION

The situation in China at present due to excessive borrowing is grave and the urgency to tackle the situation is of utmost importance. China must shun its desperation to keep up with a very high growth rate and must be willing to spur economic activity based on indigenous consumption. If the same is followed it will be in the greater good of the whole society and will be in the economic interest of every country of the world.

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